Docket No. 80-708

In the Supreme Court of the United States

OCTOBER TERM, 1980

ROCCO CATENA, on behalf of himself and the Certified Plaintiff Class,

Petitioner,

vs.

CAPITOL INDUSTRIES, INC., et al.,

Respondents.

Reply Brief In Support of Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

DAVID B. GOLD, ESQ.
PAUL F. BENNETT, ESQ.
GEORGE DONALDSON, ESQ.
JOHN W. ALLURED, ESQ.
DAVID B. GOLD, a Professional Law Corporation
120 Montgomery St.,
Suite 650
San Francisco, CA 94104
Telephone: (415) 981-2440
and
EDITH S. NEWMAN, ESQ.
Attorneys for Petitioner on behalf of himself and the Certified Plaintiff Class

BORG PRINTING COMPANY OF CALIFORNIA, 345 FIRST STREET, SAN FRANCISCO 94105

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PETITIONER'S REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

I

PRELIMINARY STATEMENT

Respondents do not dispute that a conflict exists between the Ninth and Second Circuits concerning the standards for recklessness liability under §10(b) of the Securities Exchange Act of 1934 and its amplifying regulation, Rule 10(b)(5). Nor do they contend that the questions presented on this issue are unimportant. Instead, Respondents argue that a writ of certiorari should not be granted because Petitioner has mischaracterized the opinions below, thereby rendering "illusory" the questions presented on the issue of the standard of recklessness liability.

In this Reply Brief, Petitioner demonstrates that if there has been any mischaracterization of opinions, it is Respondents' treatment of the district court's opinion.

The district court plainly did not find, as Respondents assert, that the conduct challenged by Petitioner was not actionable because Respondents only acted negligently. What the district court found was that Respondents did not act with a "fraudulent intent" and thus could not be liable under this Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). In light of that finding, the district court deemed it inappropriate to even consider whether Respondents' conduct could be characterized as negligent.

This legal ruling, which was affirmed by the Ninth Circuit, is completely at odds with the position of the Second Circuit, and there is nothing in Respondents' brief that even suggests otherwise. Accordingly, we respectfully submit that this Court should review this issue because it is one of major importance affecting the proper enforcement of the federal securities laws.

Respondents also admit that a conflict exists among the circuits respecting the standards for appellate review of a finding of recklessness. They claim, however, that this Court should not review the question because Petitioner "waived" it below and because the issue is, in any event, unimportant. As we will show, the claim of "waiver" is sham, and the issue is certainly important enough for this Court's consideration and clarification.

II

ARGUMENT

A. Respondents Erroneously Contend That the District Court Found Their Conduct to be Negligent

In the course of complaining that Petitioner has mischaracterized the opinions below, Respondents assert that the district court made an express finding that Respondents acted negligently in connection

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with the challenged conduct.* Respondents'

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* Respondents also assert that Petitioners' statement of facts is "rife with ... inaccuracies and exaggerations." Respondents' Brief at 2. After making this bald statement, Respondents offer little evidence of these alleged inaccuracies, claiming instead that they do not wish to burden the court with a refutation of these factual contentions. In the one example they do cite, (footnote 3, page 2 of Respondents' Brief) it is asserted that Respondents' expert and two independent auditing firms "opined that the accounting method employed by Capitol for sales returns was perfectly appropriate." That statement is simply not correct. No expert, including the one called by Respondents, opined that the method employed by Capitol was within even the framework of generally accepted accounting principles. In fact, Respondents' own expert admitted that the method urged by Petitioner would have been preferable to that actually employed by Capitol during the class period. R.T. 7889-7893; R.T. 9337-9340. Similarly, the contention that "two independent accounting firms" endorsed Respondents' sales return policy is totally lacking in factual support or judicial finding. See, e.g., Ex. OR-20. (For a complete discussion of these factual matters, the Court's attention is directed to Plaintiff's Post-Trial Reply Brief, Vol. I, at pp. 79-82.)

Irrespective of this particular factual dispute, we believe it is important to note what Respondents do not dispute, which is that they reversed millions of dollars from reserves to income without any public disclosure. This, of course, is one of the key issues in the case, and nowhere in Respondents' brief do they deny that this conduct occurred.

Brief at 7. In fact, the district court specifically refused to consider this issue because it found that "in the absence of a sinister motive or culpable recklessness, neither of which was present here, these actions do not constitute a basis for relief in a 10(b)(5) lawsuit in light of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). Under these circumstances, the issues that were litigated so exhaustively at the trial become reduced to questions of policy, or wisdom, or 'GAAP' or even negligence, and it is unnecessary and inappropriate for this court to express its views concerning them." App. at 11-12.

Similarly, Respondents' assertion that the district court found that there "conduct could not be characterized as reckless in nature" is also incorrect. Respondent's Brief at 4. As the portion of the opinion quoted above clearly shows, the district court found that Respondents did not act with "culpable recklessness." Although it

is understandable that Respondents would like to ignore the qualifying adjective -- "culpable" -- it cannot be ignored if the decision below is to be properly understood. The plain meaning of the phrase "culpable recklessness" is that there is one form of recklessness that results in liability (i.e., "culpable recklessness"), while other forms of recklessness do not (i.e., "non-culpable recklessness"). Under the district court's view, what distinguishes actionable or culpable recklessness from non-actionable or non-culpable recklessness is the defendant's state of mind. Stated in another way, reckless conduct viewed objectively is not sufficient to impose Rule 10b-5 liability; there must also be a threshold finding of a "sinister" or "fraudulent" state of mind.*

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* In affirming, the Ninth Circuit endorsed the concept of "culpable recklessness." App. at 3.

As we pointed out in our Opening Brief, this standard of recklessness liability, which was explicitly affirmed by the Ninth Circuit, is radically different from that of the Second Circuit, which has held that recklessness is to be viewed objectively and without regard to defendants' "good faith" intentions. Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46 n.15, 47 (2d Cir. 1978). There is simply nothing in Respondents' brief that disputes this conclusion.

Finally, it is significant that Respondents do not dispute the importance of this issue. As we pointed out in our Opening Brief, Section 10(b) is the only practical remedy for "open market" purchasers of the stock of public reporting companies. In these circumstances, where the integrity of the securities markets is dependent upon the investing public's trust and confidence, it is essential that consistent, objective standards be established for imposing Sec-

tion 10(b) liability. We submit that the integrity of the securities market is and will continue to be threatened so long as uncertainty exists respecting the remedies available to those who purchase. As we have shown, the conflict and confusion that presently exists with respect to the standards of recklessness liability are a direct result of this Court's decision in Ernst & Ernst v. Hochfelder, supra. We respectfully ask this Court to clarify this decision and eliminate the present conflict among the circuits.

B. Petitioner Did Not Waive His Standard of Review Argument

With respect to Petitioner's question relating to the standard of appellate review on a finding of recklessness, Respondents implicitly admit that the circuits are in conflict. Respondents' Brief at 9. They argue, however, that the issuance of a writ of certiorari to review this issue would be improper because Petitioner "waived" the

issue below and because this issue is unimportant. Respondents' Brief at 8-9.

The claim of waiver is pure sham. In Petitioners' Opening Brief on appeal to the Ninth Circuit, he pointed out that the appeal involved a dispute concerning the legal effect of facts to which the clearly erroneous rule did not apply. Opening Brief at 8, n*. Moreover, when the Ninth Circuit ruled that there were mixed questions of law and fact and then incorrectly applied the clearly erroneous standard, Petitioner immediately moved for rehearing on this issue. Obviously, therefore, Petitioner did not "waive" the issue.

As for the importance of the issue, we point out that the question we presented arises in the context of the appellate review of all securities cases involving mixed questions of law and fact such as recklessness. Moreover, these mixed questions arise in numerous other contexts, e.g.,

discrimination cases. Thus, this Court's decision will have wide applicability. Moreover, a consistent appellate approach to reviewing these questions (which does not presently exist) is essential to the uniform application of laws. In sum, the issue is certainly important enough for this Court's consideration and clarification. The writ of certiorari should accordingly issue.

III

CONCLUSION

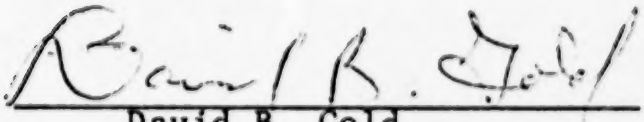
For the reasons stated in this Reply Brief and in our Opening Brief, the writ of certiorari should be granted.

Dated: December 16, 1980

David B. Gold
A Professional Law Corporation

and

Edith S. Newman



David B. Gold